



**DEFENSE CONTRACT AUDIT AGENCY**  
**DEPARTMENT OF DEFENSE**  
8725 JOHN J. KINGMAN ROAD, SUITE 2135  
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

PQA 720.7.A.123.5

June 28, 2005  
05-PQA-045(R)

**MEMORANDUM FOR REGIONAL DIRECTORS, DCAA**  
**DIRECTOR, FIELD DETACHMENT, DCAA**

**SUBJECT:** Audit Alert on Emphasizing Certain Incurred Cost Audit Procedures as a Result of the PCIE-based Review Findings

This audit alert is being issued to address certain incurred cost audit procedures that require emphasis due to the findings from the FY 2005 PCIE-based review of incurred cost audits. Auditors should apply the guidance in this memorandum immediately to any open assignments as well as new assignments set up until APPS changes are in place. Revisions to the applicable CAM sections, standard audit programs, and audit report shells, to reflect this guidance, are currently in process.

The review results disclosed the following systemic noncompliances:

- Lack of sufficient evidence to provide an opinion on incurred labor costs when the concurrent verification of labor (i.e., MAAR 6) was not performed. The PCIE-based review found assignments where a required MAAR 6 was not performed and no other procedures were performed to verify selected labor transactions from the labor distribution to source timekeeping records.
- Lack of sufficient evidence to provide an opinion on amounts claimed under time and material contracts. The PCIE-based review found that significant amounts claimed under time and material contracts (i.e., contract rates and hours incurred) were not verified for compliance with contract provisions, and claimed hours were not traced to labor distribution reports.
- Lack of documentation demonstrating the auditor's understanding of internal controls for nonmajor contractors, especially low risk nonmajor contractors. The PCIE-based review found that there was not sufficient documentation evidencing that the auditor obtained a sufficient understanding of internal controls when performing the nonmajor incurred cost audits, which is required for all audits performed in accordance with the Government Auditing Standards.
- Indirect rate agreement letters being executed prior to final supervisory review of the working papers and report. The PCIE-based review found several instances where the rate agreement letters were executed prior to the date the supervisor signed off on the working papers and draft report.

**GUIDANCE**

The following guidance is provided to address the conditions cited above.

SUBJECT: Audit Alert on Emphasizing Certain Incurred Cost Audit Procedures as a Result of the PCIE-based Review Findings

***A. Audit of Labor Costs When MAAR 6 is Not Performed.***

Our mandatory annual audit requirements (MAARs) represent DCAA basic criteria and core requirements for providing an opinion on incurred costs that complies with the Government Auditing Standards. MAAR 6 is performed in the year the labor costs are incurred and includes tests to ensure the existence of the employee, the reliability of the time records, and the charging of the observed time to the proper cost objective (CAM 6-402). These steps include verifying the timekeeping records to the labor distribution. The PCIE-based review found several cases when the required MAAR 6 verifications were not performed, and no other procedures were performed to verify that the labor distribution reconciles to source timekeeping records.

While no subsequent year incurred cost audit step can substitute for the missed opportunity to conduct the required physical observation of an employee in the year the costs are being incurred, procedures should be performed as part of the MAAR 9 steps (Payroll/Labor Distribution Reconciliation and Tracing) to verify the labor distribution is supported by source documents. Therefore, during the risk assessment, auditors should assess as to whether a required MAAR 6 has been performed. When a required MAAR 6 was not performed, and no tests were performed in other audits to verify the labor distribution to source documents, auditors should select a sample of transactions from the contractor's labor distribution and trace those amounts to source documents (i.e., timekeeping records and work authorizations) during the MAAR 9 steps. In determining the level of MAAR 9 testing necessary, the auditor should consider both the guidance in CAM 6-402d (1) through (7) as well as likely extent of the MAAR 6 tests that were not performed. Even though MAAR 9 procedures are performed, the report should still contain the scope limitation for the nonperformance of the concurrent MAAR 6 verification as discussed in CAM 6-105.4 and 10-504.3b.

***B. Audit of Claimed Amounts Under Time and Material Contracts.***

The PCIE-based review found that significant amounts claimed under time and material contracts were not verified for compliance with contract provisions, and claimed hours were not traced to labor distribution reports. Audits of claimed amounts under time and material (T&M) contracts should include sample tests of amounts to verify the (i) claimed contract labor rates and related labor categories/classifications to the T&M contract labor rate provisions, (ii) claimed labor hours to the labor distribution records and (iii) claimed reimbursable amounts to the job cost ledgers and supporting documentation (CAM 6-300 and/or 6-500). Schedule K of the contractor's submission details the claimed amounts by labor hours, labor rates and cost reimbursable items (e.g., material costs). CAM 6-204 provides additional guidance for the audit of T&M contracts. Auditors should obtain an understanding of the T&M contract clauses (i.e., review applicable T&M contract briefings) during the risk assessment and perform the necessary audit steps to obtain sufficient evidence to provide an opinion on the T&M amounts claimed.

***C. Obtaining and Documenting an Understanding of Internal Control for Nonmajor Contractor Audits.***

SUBJECT: Audit Alert on Emphasizing Certain Incurred Cost Audit Procedures as a Result of the PCIE-based Review Findings

Auditors are required to document their understanding of contractor internal controls in every audit performed in accordance with the Government Auditing Standards. For nonmajor contractors with ADV greater than \$15 million, this should be accomplished by completing or referencing a completed Internal Control Questionnaire (CAM 5-111.1). This step is required even when control risk is assessed as maximum (CAM 5-111.2). The PCIE-based review found several nonmajor incurred cost audits where this understanding was not adequately documented (or referenced) in the working papers. The PCIE review also found many of the ICQs incomplete, noncurrent, or blank.

As stated above, even examinations of contractors with less than \$15 million ADV, require the auditor to obtain and document an understanding of internal controls. However, Agency guidance does not require the completion of an ICQ. Although the completion of an ICQ is preferable, due to the low risk of these audits, Agency guidance allows the auditor to utilize more simplified alternative procedures provided they adequately document the required understanding of the internal controls. For these examinations, auditors have the option of documenting their understanding in a narrative format similar to the example found in CAM 10-504.6b. The PCIE-based review found many instances where these narratives were not prepared, nor was there a complete ICQ on file. For desk reviews (as opposed to examinations) of low risk contractors less than \$15 million, these steps are not necessary.

***D. Executing the Indirect Rate Agreement Letter Prior to Supervisory Review***

Auditors and supervisors should not execute the indirect rate agreement letter for audit determined rates prior to the supervisor review and FAO manager review, if applicable, of the working papers and draft report. The PCIE-based review found several instances, where the rate agreement letter was executed prior to the final sign-off of the working papers by the supervisor.

**CONCLUDING REMARKS**

If FAO personnel have any questions, they should contact regional personnel. If regional personnel have any questions, they should contact Quality Assurance Division, at (703)767-2250.

/Signed/  
Robert DiMucci  
Assistant Director  
Policy and Plans

DISTRIBUTION: C